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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF RIO RICO UTILITIES, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS WATER AND WASTEWATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO: WS-02676A-12-0196

RIO RICO UTILITIES, INC.

INITIAL CLOSING BRIEF

May 3, 2013

Arizona Corporation Commission
DOCKETED

MAY 3 2013

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TABLE OF ABBREVIATIONS AND CONVENTIONS

Rio Rico Utilities, Inc. uses the following abbreviations in citing to the pre-filed testimony and hearing transcripts in this brief. Other documents that were admitted as exhibits during the hearing are cited by hearing exhibit number. The parties' final schedules setting forth their respective final positions will be cited in abbreviated format as follows: Company Final Schedule XXX, Staff Final Schedule XXX; RUCO Final Schedule XXX.* Other citations to testimony and documents are provided in full, including (where applicable) the Corporation Commission's docket number and filing date.

RIO RICO UTILITIES, INC.
PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Tom Bourassa (Rate Base)	**A-1**	Bourassa Dt.
Direct Testimony of Tom Bourassa (Cost of Capital)	**A-2**	Bourassa COC Dt.
Rebuttal Testimony of Thomas J. Bourassa (Rate Base)	**A-3**	Bourassa Rb.
Rebuttal Testimony of Thomas J. Bourassa (Cost of Capital)	**A-4**	Bourassa COC Rb.
Rejoinder Testimony of Thomas J. Bourassa (Rate Base)	**A-5**	Bourassa Rj.
Rejoinder Testimony of Thomas J. Bourassa (Cost of Capital)	**A-6**	Bourassa COC Rj.
Direct Testimony of Greg Sorensen	**A-7**	Sorensen Dt.
Rebuttal Testimony of Greg Sorensen	**A-8**	Sorensen Rb.
Rejoinder Testimony of Greg Sorensen	**A-9**	Sorensen Rj.
Direct Testimony of Peter Eichler	**A-10**	Eichler Dt.

* RRUI, Staff and RUCO filed their respective Final Schedules on April 23, 2013.

RESIDENTIAL UTILITY CONSUMER OFFICE
PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of William Rigsby (Cost of Capital)	**RUCO-1**	Rigsby COC Dt.
Surrebuttal Testimony of William Rigsby (Cost of Capital)	**RUCO-2**	Rigsby COC Sb.
Direct Testimony of Timothy Coley (Redacted)	**RUCO-4**	Coley Redacted Dt.
Direct Testimony of Timothy Coley (Rate Design)	**RUCO-5**	Coley Dt.
Surrebuttal Testimony of Timothy Coley	**RUCO-6**	Coley Sb.

STAFF
PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of John Cassidy	**S-1**	Cassidy Dt.
Surrebuttal Testimony of John Cassidy	**S-2**	Cassidy Sb.
Direct Testimony of Mary Rimback	**S-3**	Rimback Dt.
Surrebuttal Testimony of Mary Rimback	**S-4**	Rimback Sb.
Direct Testimony of Jian Liu	**S-5**	Liu Dt.

OTHER PORTIONS OF THE RECORD

	Hearing Exhibit
RUCO's Response to RRUI's 6.1	**A-11**
Morningstar Exhibits- SBBI 2012 Valuation Yearbook	**A-12**
Major U.S. Stock Market Indexes WSJ Bon Yields- 3 year average	**A-13**
Corporate Borrowing Rates And Yields	**A-14**
Duff & Phelps Report p. 40 The Size Study	**A-15**
Settlement Summary	**A-16**
Settlement Summary II	**A-17**
Correction: Revised TJB-COC-2	**A-18**
RRUI's Response to RUCO 13.1	**RUCO-3**
RUCO's Notice of Errata	**RUCO-7**
Excerpt from Liberty Water Web Page	**County 1**
03/26/13 Letter from Suarez to RRUI	**County 2**
Excerpt from Liberty Water Web Page on rates	**County 3**
Liberty Water Organization Chart	**County 5**
Excerpts from Phillips	**SCVUSD-1**
Federal Reserve Chairman Bernanke's Press Conference Transcript	**SCVUSD-2**
Chart of Treasury Rates	**SCVUSD-3**
Morningstar SBBI Book	**SCVUSD-4**

	Hearing Exhibit
William Sharpe's book on Investments	**SCVUSD-5**
VIX Chart	**SCVUSD-6**
Duff & Phelps Report Page	**SCVUSD-7**
WSJ Excerpts U.S. Treasury Rate Quotes from March 22, 2013	**SCVUSD-8**
Morning Star Excerpt- SBBI 2010 Valuation Yearbook	**SCVUSD-9**

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Rio Rico Utilities, Inc. ("RRUI" or "the Company") hereby submits the following Initial Closing Brief in support of its application for rate increases for its water and wastewater utility divisions.[1]

I. INTRODUCTION

RUCO, Staff and the Company have reached agreement on three of the four components of new rates in this rate case—rate base, operating expenses and rate design. The three parties also agree on the appropriate capital structure. All that is left to reach just and reasonable rates is to determine a fair rate of return on RRUI's fair value rate base. The return recommended by the Company—9.5 percent—is commensurate with the risks the Company faces and will ensure the continued attraction of capital necessary for the provision of safe and reliable water and wastewater utility service. The returns recommended by RUCO and Staff—8.2 and 8.25 percent, respectively—are simply too low.

The County and School District did not reach agreement with the other parties. Nor did either party submit any evidence to support the adoption of a different rate base, different operating expenses, or a different capital structure or rate design than that recommended by RUCO, Staff and the Company. Notably though, the Company's proposed final rates reflect a 5 percent reduction for the School District minimizing the impact of rate increases.[2]

In this closing brief, the Company focuses on two areas: (1) why the rate base, operating expenses, capital structure and rate design recommended by RUCO, Staff and the Company are in the public interest and should be adopted; and (2) why adoption of the

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[1] The key for abbreviations and citations to a witnesses' pre-filed testimony is set forth in the Table of Abbreviations and Conventions in pages ii to v following the Table of Contents. The table also lists the hearing exhibit numbers of the parties' pre-filed testimony. Other hearing exhibits are cited by the hearing exhibit number and, where applicable, by page number, e.g., Ex. R-13 at 2. The transcript of the hearings is cited by page number, e.g., Tr. at 1.

[2] RRUI's Notice of Filing Final Schedules at Exhibits 5 and 6. RRUI is proposing to give the School District a percent discount off the regular rates.

return on equity ("ROE") recommended by either Staff or RUCO would not result in just and reasonable rates.[3]

II. COMMISSION APPROVAL OF THE RATE BASE, OPERATING EXPENSES, AND RATE DESIGN AGREED TO BY RUCO, STAFF AND THE COMPANY IS IN THE PUBLIC INTEREST

Rate cases are not static. The filing of an application for new rates starts a roughly 9-month long process of information exchange between the parties through data requests and prefiled testimony. Based on this exchange of information, the positions of the parties continue to evolve as the case proceeds.[4] "Pretty frequently" the parties' positions transform to the point where one or more issues in dispute are fully resolved.[5] If anything, it would be unusual for the parties' positions on all of the issues to remain the same throughout the case.[6] This case was certainly no exception.

By the time of the Company's rejoinder filing, there was only one rate base issue in dispute. This issue arose because RRUI continued to depreciate some plant that should have been retired.[7] This oversight can be traced to the inadequacy of the plant records inherited from Liberty's predecessor, affecting two water and two wastewater plant accounts.[8] As a consequence, both accumulated depreciation and depreciation expense were overstated and the three parties could not agree on a remedy.

Although several expense issues were resolved, there were still a few disputes over the income statement at issue in rejoinder testimony.[9] Both Staff and RUCO disputed the amount of the corporate cost allocation. Likewise, both parties opposed the Company's

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3 To the extent that the School District and/or County offer argument in an effort to convince the Commission to adopt lower rates and/or other relief currently not known to the Company, RRUI will respond in its reply brief.

4 Tr. at 439:4-20 (Rigsby), 450:4-8 (Fox).

5 Tr. at 450:9-13 (Fox).

6 Tr. at 415:16 – 416:1 (Bourassa).

7 Bourassa Rb. at 5:19-20.

8 Bourassa Rj. at 10:7-9. *See also* Bourassa Rb. at 8:4-5.

9 Issues resolved prior to trial were corporate costs allocations and the employee benefits expense.

request for declining usage and purchased power adjusters. There was also disagreement between Staff and RRUI over employee benefits expense and between RUCO and the Company over incentive pay and the amortization period for rate case expense. Finally, while the parties had made no pretrial progress on the ROE, they did agree on the capital structure and resolved all material issues with rate design by the time the Company's rejoinder filing was docketed.

On the first day of hearing, Staff and the Company reached agreement on the remaining rate base and operating expense issues in dispute, and on the general outline of a rate design.[10] On day two, RUCO and RRUI reached agreement to resolve the remaining issues that were still in dispute between those two parties.[11] As reflected in the final schedules filed by Staff, RUCO and RRUI, the sole issue still in dispute between these three parties is the ROE.[12]

As noted in the introduction, the County and School District did not join the other three parties in resolving issues in dispute. But neither did these two parties take a specific position on any issue in dispute or file final schedules reflecting positions on rate base, operating expenses, capital structure or rate design different than what Staff, RUCO and RRUI agree are reasonable in this rate case. As such, the evidence and underlying record on those issues is undisputed. RRUI is not necessarily suggesting that a "courthouse steps" settlement is the preferred route to new rates. Even so, just because a settlement occurs on the courthouse steps does not mean it is unfair, unreasonable, and/or contrary to the public interest. As explained below, the rate base and operating expense levels recommended by RUCO, Staff and the Company are the result of significant effort,

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[10] Ex. A-16. *See also* Tr. at 31:20 – 35:15, 265:3 – 268:2 (Krygier).
[11] Ex. A-17; Tr. at 401:25 – 405:13 (Krygier).
[12] *See* Tr. at 439:25 – 440:21 (Rigsby), 450:14 – 452:8 (Fox).

based on substantial evidence, and when combined with the agreed upon capital structure and a reasonable ROE (not Staff's or RUCO's), will result in just and reasonable rates.[13]

A. The Rate Base and Depreciation Expense Recommended by RUCO, Staff and the Company Are Reasonable and Based on Used and Useful Plant in Service.

As stated, there was only one rate base issue in dispute between the Company and RUCO and Staff. Specifically, the Company depreciated some plant that it should have retired.[14] RRUI recommended retiring a number of plant items, including removing the plant and the accumulated depreciation.[15] Initially, the three parties sought to remedy the problem in different ways and no consensus was reached.[16] The remedy the Company recommended, and Staff and RUCO ultimately accepted, is entirely consistent with the recent Bella Vista Water Company Decision No. 72251 addressing a similar issue.[17]

The problem, as the record shows, is that no matter how well Liberty runs its utilities, it is still stuck with poor record keeping by its predecessors.[18] As a result, and despite the adoption of a retirement policy, sometimes plant that should be retired remains in rate base. The resolution of this issue between the three parties results in (1) a finding of fair value rate base equal to $7,731,209 (water),[19] and $4,790,738 (wastewater), which RUCO and Staff both testified was fair and reasonable;[20] and (2) a level of depreciation expense equal to $441,453 (water) and $223,774 wastewater,[21] which eliminates any

[13] *Id.*
[14] Bourassa Rb. at 5:19-20.
[15] Bourassa Rb, at 5:10-17.
[16] Bourassa Rb. at 6:13-18.
[17] *E.g.*, Bourassa Rb. at 7:15 – 8:2; Bourassa Rj. at 7:9-20.
[18] Bourassa Rj. at 10:7-9.
[19] Company Final Schedules A-1 and B-1 do not reflect the agreed upon water division rate base of $7,731,209 due to a $60 error in the customer deposits balance. The Company acknowledges its error and agrees with the Staff and RUCO customer deposits balance and rate base of $7,731,209 for the water division (Company Final Schedule B-2, page 1).
[20] Tr. at 440:15-18 (Rigsby), 450:14-17 (Fox).
[21] Company Final Schedule C-1, page 2.2.

potential overstatement or over-recovery by the Company.[22] In addition, the parties' agreement that RRUI be put on notice in this order that a repeat of this issue could result in the imposition of penalties is intended to ensure that the Company remedies this problem permanently.[23]

B. The Remaining Expense Levels are Reasonable and Prudent and Reflect the Expected Level of Costs RRUI will Experience During the Time Rates Will Be in Effect.

1. Corporate Cost Allocation

The Presiding Judge is certainly familiar with the corporate cost allocation that is part of Liberty's operations in Arizona and the several other states where Liberty owns and operates water, wastewater, gas and electric utilities.[24] The corporate cost allocation was an issue in the last RRUI rate case, Decision No. 72059 (January 6, 2011), and in the last rate case for Bella Vista Water Company, Decision No. 72251 (April 7, 2011), both of which were heard by Judge Rodda. In simple terms, this case represented another step in the continuous effort by the Liberty utilities in Arizona to meet the burden of proof to show that Liberty's corporate cost allocation is both necessary to its provision of water and wastewater utility service and reasonable and prudent in its cost by maximizing use of direct billing, following the procedures outlined in the cost allocation manual and increasing the amount of documentation of each accounting transaction. This case demonstrated that Liberty has significantly improved its cost allocation process. The parties did not dispute issues such as the allocation methodology and certain types of costs being acceptable for recovery. While this effort will continue in future rate cases, the resolution in this case—an expense level agreed to by the Company that is more than

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[22] Tr. at 440:9-14 (Rigsby) and 450:21-25 (Fox) (testifying that agreed upon expense levels were reasonable and prudent).

[23] Staff and the Company agree on the following language, "On a going forward basis, RRUI shall accurately track and record plant additions, plant retirements, depreciation expense and accumulated depreciation. RRUI's failure to do so may subject the Company to sanctions, fines or other penalties."

[24] Sorensen Dt. at 2:7-9.

$55,000 lower annually than the amount the Company requested (and still believes is necessary, reasonable and prudent)—is a reasonable adjusted test year expense level under the circumstances of this case.[25]

2. Employee Benefits – Pension Plan

Late in 2012, while this rate case was pending, the Company's parent announced the creation of a new pension plan for its employees.[26] This pension plan is an important tool in recruiting qualified personnel to run Liberty's operations.[27] RUCO, Staff and the Company are in agreement that the costs of the plan are reasonable and prudent and known and measurable, and that a total expense level of approximately $45,000 ($32,891 and $11,811 for water and wastewater, respectively) is appropriate.[28] Additionally, in order to ensure that the Company does not fail to initiate its pension plan with actual contributions made beginning in 2013 as intended, RRUI has suggested and agreed to (1) make a compliance filing reflecting that the pension fund payments have been made in 2013; and (2) an accounting order that would allow it to track any amounts that are lower than the amounts authorized in this case.[29]

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[25] Tr. at 440:9-18 (Rigsby), 450:14-17 (Fox).

[26] Sorensen Rb. at 6:1-4; Sorensen Rj. at 5:12-21; Tr. at 394:3-7 (Sorensen). A summary of the plan, which remains confidential, is being provided to Judge Rodda and the parties concurrently with this brief. The executed, official plan documents will be provided as soon as they are available. *See* Tr. at 394:23 – 395:15 (Sorensen).

[27] Sorensen Rb. at 6:14-18; Sorensen Rj. at 5:1 – 8:11.

[28] Sorensen Rb. at 6:8-11; Sorensen Rj. at 7:16-20; Tr. at 394:14-17 (Sorensen). *See also* Tr. at 440:9-14 (Rigsby) and 450:21–25 (Fox) (testifying agreed upon expense levels were reasonable and prudent).

[29] Ex. A-17, n.1. The Company's understanding is that the accounting order would create a regulatory liability in the event of major changes in the level of pension funding. The Company does not believe it should face a liability for fluctuations in the annual amount of pension contributions that arise strictly from changes in personnel, any more than it would expect a regulatory asset to be created if, for example, Mr. Krygier's pension contribution were to increase each year for the next few years between rate cases. *See also* Tr. at 394:18-22 (Sorensen). The goal of the regulatory liability is to create assurances to RUCO that the expense would be incurred at the level authorized in rates, and if not, captured on the balance sheet accordingly. Tr. at 403:14-19 (Krygier).

3. Incentive Compensation

RUCO initially recommended adjustments to wages and salary in the amount of almost $30,000 ($19,997 for water and $9,448 for wastewater). As with all resolutions, there is a give and take between the parties and, on this expense, RUCO agreed to drop its recommended adjustment.[30] As a result, the jointly recommended expense level is reasonable and prudent for a program that is an integral part of Liberty's compensation plan as it assists in attracting the most qualified personnel possible to fill needed positions, is based on customer service oriented metrics, and is a normal and customary annual expense of this Company.[31]

4. Nogales Wastewater Treatment Expense

Although it was never an issue between Staff and the Company, RRUI and RUCO remained in disagreement over the level of this expense up until day two of the hearings. In truth, both parties' positions were reasonable. From the Company's point of view, the test year expense level was the only known and measurable starting point.[32] While the expense level had changed under a new contract, the City's failure to reconcile the annual amounts in a timely manner left all parties unsure of how the test year level of expense had changed.[33] In this light, RUCO correctly pointed out that the Company was no longer paying the test year expense level, it appeared that the expenses were decreasing, and an extrapolation using the most recent billings by the City was more reflective of this expense going-forward.[34]

In the end, the resolution now seems easy and obvious. First, the revenue requirement will be based on RUCO's recommended expense level, which is based on the

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[30] Ex. A-17.

[31] Sorensen Rb. at 4:1 – 5:9; Sorensen Rj. at 2:9 – 3:20.

[32] Bourassa Rb. at 45:9 – 46:12.

[33] Bourassa Rj. at 29:1-23.

[34] Coley Sb. at 35 – 36.

amount the Company is currently paying.[35] Second, an accounting order will be issued allowing the Company to track any additional amounts it is required to pay for treatment after the City gets around to truing up the charges.[36] Then, in a future rate case, the Company can seek to recover any additional amounts paid as a regulatory asset; or if the costs decrease, the customers will receive the benefit of a regulatory liability.[37]

5. **Amortization of Rate Case Expense**

RUCO, Staff and the Company have always agreed that $335,000 of total rate case expense, allocated between the two divisions based on customer numbers, was fair and reasonable. The dispute was limited to RUCO's recommended 4-year rather than 3-year amortization. In agreeing to a 3-year amortization period, the parties' joint recommendation results in a reasonable expense level that reflects Liberty's policy to bring its companies in for rates in roughly three-year intervals, and RRUI's history under Liberty ownership.[38]

6. **Declining Usage Adjustment and Purchased Power Adjuster**

That the Company's revenues from water sales have declined precipitously under the rate designs approved in the most recent rate orders was never in dispute.[39] Nor was there any dispute that the Company's electric service provider, UNS Electric, will be getting rate cases in the near future, increasing RRUI's cost of service. Nevertheless, in reaching resolution on rate base and operating expenses, the Company agreed to withdraw its request for these two adjustments.[40]

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[35] *See* Ex. A-17.
[36] *See* Ex. A-17, n. 4.
[37] The Company understands that it is possible it will pay lower amounts and that a regulatory liability would be created. It further understands that neither RUCO nor Staff are waiving their rights to object to recovery of amounts tracked per the accounting order in a future rate case. Tr. at 406:3-9 (Krygier).
[38] Bourassa Rb. at 34:13 – 35:2; Bourassa Rj. at 24:3-14. *See also* Tr. at 440:9-14 (Rigsby) and 450:21-25 (Fox) (testifying that agreed upon expense levels were reasonable and prudent).
[39] *See, e.g.,* Rimback Sb. at 13:6-15.
[40] *E.g.,* Exs. A-16 and A-17.

III. COST OF CAPITAL

A. Capital Structure

RUCO, Staff and the Company agree to a capital structure consisting of 100 percent equity for purposes of this rate case, which is consistent with the Company's actual capital structure.[41] This agreement is based on Staff's recommendation, which recommendation was first adopted by RUCO, and then by RRUI. In the final analysis, the choice between the hypothetical and the actual capital structure does not seem to be material.[42] While the use of a hypothetical capital structure will include interest synchronization, which will lower operating expenses, it will also increase the cost of equity throughout greater financial risk, effectively offsetting the benefit of the interest synchronization.[43]

B. Return on Equity (ROE)

Judge Rodda was right—it's too bad RUCO, Staff and the Company could not resolve the ROE as well. Then the parties would have avoided further discussion of the DCF and CAPM. These two financial models have become the pillars of ROE determinations for more than a decade now in Arizona ratemaking. A settlement on ROE would have avoided the soporific debate over historic or future growth, and we would have been able to skip the nitpicking over the spot, 3-year, or 30-year treasury rates and interest rates for the DCF. Nor would anyone have concerned himself or herself further over whether the CAPM is weak, semi-strong, or strong in favor of the Efficient Market Hypothesis.

Likewise, the parties would not have to bantered further over Mr. Bourassa's attempt to show the practical limits of the two VIP models with the Build-Up Method

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41 Bourassa COC Rj. at 2:25-26; Cassidy Sb. at 1:25-26; Rigsby COC Sb. at 6:15-17.
42 Cassidy Dt. at 6; Rigsby COC Sb. at 6:15-17; Bourassa COC Rj. at 2:25-26.
43 Tr. at 101 – 108 (Bourassa).

(sponsored by Duff & Phelps), the Small Size Premium (apologies to Ms. Wong and Dr. Zepp), and the Company Specific Risk Premium. Since the parties had already agreed on the capital structure, we also wouldn't have been bothered over whether it's a Hamada, or some other thing that appears loosely known as the "financial risk adjustment." Even the question of the mysterious origin of the Staff Economic Assessment Adjustment would have been shelved, at least for this case.

Alas, the search for the great resolution came up one issue short. Now, to quote the great golfer Bobby Jones – "we have to pay the ball where it lies." But that does not mean there isn't a chance to par the hole. Maybe Mr. Bourassa is right this time that something just isn't right with Staff and RUCO's recommended ROEs of 8.2 and 8.25 percent. There is no financial model, no method, no adjustment up or down, and no substantial evidence in this case that can overcome one simple hurdle: returns of 8.2 or 8.25 percent do not and cannot pass the comparable earnings standards set forth in *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-93 (1923); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

C. <u>The Applicable Legal Standards</u>

While the Arizona Constitution grants the Commission formidable power over utility rates in Arizona, it is the federal courts that have largely defined how a reasonable return should be determined. This makes sense. Regulated utilities operate mostly as state certified monopolies. Just as the state regulators seek to ensure that the monopoly utility does not discriminate or overcharge its captive customers, there must be something to ensure that those same regulators do not use the monopoly obligation to force below cost service on the captive utility. The something is the "comparable earnings" standard.

In the seminal 1923 *Bluefield* decision, the U.S. Supreme Court stated the criteria for determining whether a rate of return is reasonable:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments on other business undertakings which are attended by corresponding risks and uncertainties .... The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.[44]

The Court went on to hold: "[r]ates which are not sufficient to yield a reasonable return *on the value of the property used at the time it is being used to render the service* are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment."[45]

In *Hope*, the U.S. Supreme Court further defined the guarantees afforded to regulated utility providers under the U.S. Constitution:

> [T]he return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[46]

In summary, therefore, under *Hope* and *Bluefield*:

(1) The rate of return should be similar to the return in businesses with similar or comparable risks;

(2) The return should be sufficient to ensure the confidence in the financial integrity of the utility; and

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[44] *Bluefield*, 262 U.S. at 692-93.
[45] *Id.* at 690 (emphasis added).
[46] *Hope*, 320 U.S. at 603.

(3) The return should be sufficient to maintain and support the utility's credit.[47]

D. The Commission Should Adopt an ROE of 9.5 Percent.

There is actually no dispute that the test set forth in *Bluefield* and *Hope* applies to this rate case.[48] The dispute is over what "comparative" really means. Staff and RUCO essentially believe that the requirements of federal law are satisfied because they do a "comparison" of RRUI to proxy utility companies. This might fit with their view that all utilities share the same risk because they are all utilities.[49] Just because a DCF or CAPM model produces a value though doesn't make that value or recommendation credible. If the model results in returns on equity that obviously do not allow the utility to attract capital and maintain its value, then such returns can't be approved, not to mention there just might be something wrong with the comparative analysis. Something more than spitting out a DCF and CAPM number and then scurrying to mask the results with other vague adjustments is needed to satisfy the *Bluefield* and *Hope* test.

Over the years, the Company's cost of capital expert, Mr. Bourassa, has taken a lot of criticism for being at odds with this view of equity returns. In response, Mr. Bourassa has made several changes to the manner in which he determines a recommended ROE for his utility clients.[50] At the same time, he has looked for new and better "checks" on the DCF and CAPM.[51] This is because Mr. Bourassa recognizes that the goal is to determine what it takes to get the capital from the investor, and he simply refuses to believe that

[47] *See, e.g.*, Roger A. Morin, *New Regulatory Finance* 9-12 (Public Utility Reports, Inc. 2006) ("Morin") (summarizing the legal principles underlying the regulation of a utility's rate of return); Charles F. Phillips, Jr., *The Regulation of Public Utilities: Theory and Practice* 376-79 (Public Utility Reports, Inc. 1993) (summarizing the legal principles underlying the regulation of a utility's rate of return).

[48] *E.g.*, Rigsby COC Dt. at 7 – 8.

[49] Cassidy Dt. at 14:19 – 15:14; Rigsby COC Dt. at 19.

[50] *E.g.*, Tr. at 106:6-12 (Bourassa); Bourassa COC Rb. at 25:19-24.

[51] *See* Bourassa COC Dt. at 38 – 40.

anyone but Mr. Rigsby and Mr. Cassidy really believe that RRUI is roughly 200 basis points less risky than the sample companies.[52]

E. <u>8.2 PERCENT AND 8.25 PERCENT?</u>

RRUI is not publicly traded. It has no stock price. It has no beta. Therefore, as all parties agree, the *starting* point is the use of proxies. Collectively, the parties used several water companies and several gas utilities in their proxies groups. The following are undisputed *facts* in this rate case regarding that "sample" group:[53]

Value Line (January 18, 2013) *projects* the following expected returns on equity for these water utilities:

American States Water (AWR)	12.0%
Aqua America (WTR)	12.5%
California Water (CWT)	10.5%
Connecticut Water (CTWS)	10.5%
Middlesex Water (MSEX)	9.0%
SJW Corp. (SJW)	7.0%
Water Utility Average Projected ROE	**10.3%**

Value Line (December 7, 2012) *projects* the following expected returns on equity for those gas utilities:

AGL Resources, Inc. (GAS)	11.5%
Atmos Energy Corp. (ATO)	8.0%
Laclede Group (LG)	10.0%
New Jersey Resources (NJR)	14.0%
Northwest Gas Co. (NWN)	11.5%

52 *See* Bourassa COC Rb. at 12:3-9.
53 Bourassa COC Rb. at 8:20 – 10:24.

Piedmont Natural Gas Co. (PNY)	12.5%
South Jersey Industries, Inc. (SJI)	16.0%
Southwest Gas (SWX)	10.5%
WGL Holdings, Inc. (SJW)	9.5%
Gas Utility Average Projected ROE	**11.5%**

The currently *authorized ROE's* for the sample water utility companies as reported by AUS Utility Reports (January 2013) are as follows:

American States Water (WTR)	9.99%
Aqua America (WTR)	10.33%
California Water (CWT)	9.99%
Connecticut Water (CTWS)	9.75%
Middlesex Water (MSEX)	10.15%
SJW Corp. (SJW)	9.99%
Water Utility Average Authorized ROE	**10.03%**

The currently *authorized ROE's* for the sample natural gas distribution companies as reported by AUS (January 2013) are as follows:

AGL Resources, Inc. (GAS)	10.17%
Atmos Energy Corp. (ATO)	11.71%
Laclede Group (LG)	NM
New Jersey Resources (NJR)	10.30%
Northwest Gas Co. (NWN)	9.50%
Piedmont Natural Gas Co. (PNY)	10.40%
South Jersey Industries, Inc. (SJI)	10.30%
Southwest Gas (SWX)	10.12%
WGL Holdings, Inc. (SJW)	9.85%
Gas Utility Average Authorized ROE	**10.29%**

Again, Staff and RUCO recommend an authorized return of 8.2 and 8.25 percent, respectively, for the Company. That's 178 to 183[54] basis points lower than the average of the currently authorized ROEs for Staff and RUCO's proxy water utilities; 204 to 209[55] basis points lower than the average of the currently authorized ROEs for Staff and RUCO's proxy gas companies; and 205 to 210[56] basis points lower than the average of the currently projected ROEs for Staff and RUCO's proxy water companies.

No matter what they say Staff and RUCO can't hide these numbers. For Staff and RUCO to argue in support of their model numbers and their support for the philosophy behind the models—and then to ignore that the results are about 200 basis points off from the proxies *they put into the model*—is simply not credible for several reasons.

First, the difference between RRUI and the sample water companies is huge:[57]

Water Utility	Net Plant ($ millions)	Size Rank by Plant	Revenue ($ millions)	Size Rank by Rev.	*Duff & Phelps* COE	Lowest to Highest COE
American States Water (WTR)	$ 912.0	3	$ 419.3	3	10.01%	2
Aqua America (WTR)	$3,863.4	1	$ 755.7	1	8.32%	1
California Water (CWT)	$1,443.1	2	$ 541.5	2	10.81%	3
Connecticut Water (CTWS)	$ 422.6	6	$ 79.8	6	12.21%	6
Middlesex Water (MSEX)	$ 433.3	5	$ 106.6	5	11.61%	4
SJW Corp. (SJW)	$ 870.5	4	$ 261.4	4	11.88%	5
Average	$1,229.2		$ 344.0		10.80%	
RRUI (at February 29, 2012)	$ 28.2		$ 4.2		14.30%	

Second, the owner of stock in any of these sample companies can sell it on the market any time he chooses.[58] They could actually sell their shares on E-Trade in just a

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54 Water Proxy Group Authorized 10.03% minus 8.2% equals 183 basis points.
55 Gas Proxy Group Authorized 10.29% minus 8.2% equals 209 basis points.
56 Water Proxy Group Projected 10.30% minus 8.2% equals 210 basis points.
57 Bourassa COC Rb. at 12:3-9.
58 Tr. at 114:18 – 115:15 (Bourassa).

few minutes. RRUI's shareholder cannot just sell RRUI. If it finds a buyer, it then requires Commission approval.[59] The difference in liquidity risk between a company like RRUI and the sample companies is so significant that it equals or exceeds the differences in financial risk.

Mr. Rigsby counters that RRUI is owned by APUC and APUC is a lot like the sample companies so we do not have to consider the real world differences between RRUI and the sample companies.[60] Just because holding companies are a collection of smaller utilities does not make an investment in them the same as an investment in RRUI. Publicly traded utility "holding companies" are geographically more diverse, not subject to one regulatory jurisdiction (where a bad decision from one has less impact on the whole), have greater economies of scale, and have more revenue and earnings stability as a result.[61] It plainly follows that an investment in the publicly traded utility is less risky because the business risks are lower, and in the real world, no one, especially investors, ignores business risks.

Nor can these risks totally be ignored here without running afoul of the standards embedded in the federal constitution as identified by the U.S. Supreme Court.[62] How can one justify an 8.25 percent return for a small company like RRUI on the basis that it is a far safer investment than an investment in the sample companies? Not just safer, but 210 to 330 basis points safer.[63] That borders on the absurd.

Mr. Rigsby runs his CAPM, comes up with returns under 6 percent,[64] and then testifies he could have gone lower but was being conservative.[65] The market data from his

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[59] *See AAC R14-2-801 et seq.*
[60] *See* Tr. at 155:6-14 (Rigsby); *see also* Bourassa COC Rb. at 17:20 – 18:12.
[61] Bourassa COC Dt. 19 – 22.
[62] *See generally Bluefield*, 262 U.S. 679; *Hope*, 320 U.S. 591.
[63] Compared to the projected returns of 10.3% (water) and 11.5% (gas).
[64] *See* RUCO Final Schedule WAR-1, p 2 of 2.
[65] *See* Tr. at 176:7-11 (Rigsby).

own proxies belies his statement; we have completely turned the benefit of lower cost debt on its head. Saying that having 50 percent debt provides 225 to 230 basis points more risk for the ROE is contrary to economic theory[66] and would simply drive up the WACCs that customers have to pay, all of which is avoided by simply adopting a reasonable ROE. The ROE that the Company recommends is, itself, lower than the average ROEs for Staff and RUCO's proxy companies. The Company recommends an authorized ROE of 9.5 percent. The Staff/RUCO proxy water companies have an average authorized ROE of 10.03 percent (53 basis points higher), and the Staff/RUCO proxy gas companies have an average authorized ROE of 10.29 percent (79 basis points higher). The Company itself is recommending an ROE that is significantly lower than comparable companies earn. Staff and RUCO, however, are recommending an ROE that is completely unrelated to their own proxy companies data.

Perhaps the best illustration of the failure to meet any credible application of the comparative earnings standard is the difference in the ability of RRUI and the sample utilities to support the capital. *All* invested capital must be supported as each dollar of capital has an earnings requirement.[67] This is true, whether each dollar is recognized in rate base or not, because each dollar has capital costs and these costs must be absorbed by earnings from existing investments. As Dr. Morin states:

> The totality of a company's capital has to be serviced... Therefore, the allowed rate of return on common equity is applicable to the total common equity component of the total investments of the utility company. Anything less than that has the direct and immediate effect of reducing common equity return below the level needed to meet the capital attraction and the comparable earnings standards articulated in the Hope and Bluefield decisions. To apply an allowed rate of return to a rate base that does not maintain the integrity of that capital does not enable the company to attract

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[66] The Hamada approach indicates the financial risk is no more than 90 basis points under the Staff cost of capital analysis and no more than 90 basis points under the Company's cost of capital analysis.

[67] Bourassa COC Rj. at 13:1-12 (emphasis in original).

capital.[68]

In order for the Company to pay dividends if the Staff recommended ROE were adopted in this case, the payout ratio required to meet investor expectations will be at or near 100 percent of earnings; which is not sustainable.[69] The same problem exists under RUCO's recommended equity return.[70] The payout ratio for Staff is 94 percent; the payout ratio for RUCO is 93 percent. Using the Company's recommended ROE, the payout ratio for the Company is 71 percent.[71] By comparison, the 5-year average payout ratio for the sample companies is 71 percent.[72] If RRUI is forced to exist with the high payout ratios that result from the Staff and RUCO recommendations, the value of the equity investment in RRUI would necessarily decrease, thus further increasing risk.[73] This testimony is undisputed, and it should be obvious that a cost of capital that reduces the entities' value isn't likely to attract capital, again failing one of the critical elements of the comparable earnings test.[74]

Does all this mean the Commission should accept Mr. Bourassa's recommend 9.5 percent ROE for RRUI? Yes, actually it does. But even if the Commission does not agree that 9.5 percent were the right ROE, neither is 8.2 nor 8.25 percent. How can these recommended returns pass any sort of reasonable comparative earnings test when the investor would be better off putting his money in any average stock (9.4 percent three year average), 3-year treasuries (9.16 percent annualized return), or even corporate bonds (8.35

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[68] *Morin* at 497 – 498.
[69] Ex. A-18 at Table 1.
[70] Ex. A-18 at Table 2.
[71] Ex. A-18 at Table 3.
[72] Bourassa COC Rj. at 12:24-26.
[73] Bourassa COC Rj. at 13:14 – 14:9.
[74] *See Morin* at 9 – 12 (discussing *Bluefield*).

percent average)?[75] The answer is obvious. These recommended ROEs do not meet the required comparative earnings analysis and should be rejected because they are unlawful.

IV. CONCLUSION

Based on the foregoing, RRUI respectfully requests the following relief:

a. A finding that the fair value of RRUI's property devoted to water and wastewater service is $7,731,209 and $4,790,738, respectively;

b. Approval of an overall rate of return on such rate base equal to 9.50 percent;

c. A determination of a revenue requirement for RRUI's water division of $3,385,270, which constitute increases over adjusted test year water revenues of $2,865,120, or 18.15 percent over the test year; and

d. A determination of a revenue requirement for RRUI's wastewater division of $1,596,136 respectively, which constitute increases over adjusted test year wastewater revenues of $1,402,843, or 13.78 percent over the test year.

RESPECTFULLY SUBMITTED this 3rd day of May, 2013.

FENNEMORE CRAIG, P.C.

By_______________________

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75 *See* Tr. at 180 – 183 (Rigsby).

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